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BEFORE THE ARIZONA CORPORATION COMMISSION

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Chairman

GARY PIERCE
Commissioner

BRENDA BURNS
Commissioner

SUSAN BITTER SMITH
Commissioner

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Arizona Corporation Commission
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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASE IN ITS RATES AND CHARGES BASED THEREON

DOCKET NO. W-02113A-13-0118

CHAPARRAL CITY WATER COMPANY'S OPENING BRIEF

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A. INTRODUCTION

On April 26, 2013, Chaparral City Water Company ("CCWC" or "Company") filed its Application for an adjustment to its existing rates and charges, utilizing a test year ending December 31, 2012. As the test year in its last rate case was 2006, CCWC has needed a rate increase since the time the Commission approved its prior rate increase in late 2009.[1] For the test year, calendar year 2012, CCWC's adjusted earned rate of return was only 3.26% as compared to an authorized rate of return of 10.21%.[2] Since the test year of its last rate case, CCWC has invested more than $15 million in water infrastructure throughout its service territory and its operating and maintenance costs have been significantly affected by inflation.[3] In addition to these items, CCWC is

[1] Exhibit ("Ex.") A-3 at 2.
[2] Ex. A-1 at Sch. A-1.
[3] Ex. A-3 at 7; Ex. A-1.

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seeking to include in this case all of its costs for the purchase of CAP water, a renewable resource, the use of which is supported by the water policy of the State of Arizona; CCWC also seeks to implement a surcharge to address changes in CAP related expenses. CCWC also seeks approval of inclusion of deferred depreciation and AFUDC as previously recommended by Commission Staff to address regulatory lag. CCWC further seeks to recover the costs of tank maintenance so that it may properly maintain these critical storage tanks on a going-forward basis. Finally, CCWC has requested and supported the implementation of a SIB mechanism in accordance with current Arizona Corporation Commission ("Commission") policy.

As set forth in its final schedules, the Company seeks a total increase in annual revenues of $2,727,121.[4] The Company has provided ample support for this requested increase, as evidenced by the fact that the parties have found almost identical net plant in service amounts. As such, what is not at issue here, as is often the case in other rate cases, are significant differences in the amount of plant in service or substantial adjustments to rate base as a result of a failure to support those amounts. Despite the near agreement on these issues, the parties, as demonstrated by the chart below, have substantial differences in relation to the increase to the revenue requirement to be authorized in this case:[5]

Company	Staff	RUCO
$2,727,121	$1,302, 325	$754,940

These variances arise from substantial differences in position that still exist in relation to cost of capital, certain rate base items, and operating income. Rate design is also an

[4] Company's Schedules at Sch. A-1.

[5] CCWC's final position is set forth in its final schedules filed on March 7, 2014 ("Company's Schedules"). The Commission Staff's final position is set forth in its final schedules filed on March 7, 2014 ("Staff's Schedules"). RUCO also filed its final schedules on March 7, 2014 ("RUCO's Schedules"). No other party filed final schedules.

issue in dispute between the parties. The Company's position in relation to those issues is discussed in detail below.

B. ADDITIONAL BACKGROUND

This rate case should be viewed with particular attention to the context in which it arose. In 2011, EPCOR Water (USA), Inc. ("EPCOR") purchased CCWC from American States.[6] Less than two years prior to that acquisition, the Commission had entered its decision in CCWC's most recent rate case.[7] In that case, the Commission, using CCWC's actual capital structure, approved a rate increase for CCWC and authorized CCWC to continue to use its current method of depreciation, the whole group method, based on the Commission's standard depreciation rates.[8] As noted above, since the test year in the last rate case, CCWC has invested more than $15,000,000.[9] Because EPCOR purchased a system in need of some repair, much of that has occurred under EPCOR's ownership.[10]

Since purchasing CCWC, EPCOR, as a responsible owner, has continued to ensure CCWC's compliance with Commission orders, rules and regulations and has continued to provide safe and reliable drinking water to its customers.[11] In doing so, CCWC has met its obligations under the regulatory compact. Despite this, the Commission Staff and RUCO have recommended in this case, in an ever-evolving manner, certain results-based regulation in the form of a hypothetical capital structure and "modified" vintage depreciation method. These newfound approaches to these two critical issues were done without detailed analysis, without merit, and account for the bulk of the difference in the recommended revenue increase as set forth above.

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[6] Ex. A-3 at 2-4; Decision No. 72259.
[7] Ex. A-13 (Decision No. 71308).
[8] *Id.*
[9] Ex. A-3 at 7.
[10] Ex. A-17 at 12; Ex. A-3 at 10.
[11] Ex. A-3 at 10; Ex. S-6 at Ex. KS at 11-12.

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The importance of stable, well-reasoned regulation of Arizona utilities cannot be understated. If the Commission is to continue to attract and support investment into and by Arizona utilities, the type of results-based regulation recommended by Staff and RUCO in this rate case should be discouraged.

C. COST OF CAPITAL

1. Hypothetical Capital Structure

For the first time in recent history, Commission Staff recommends in this case the use of a hypothetical capital structure for purposes of addressing cost of capital.[12] This approach is contrary to Staff's approach in many recent cases for water utilities with similar capital structures or structures with one hundred percent equity.[13] Staff's cost of capital witness, Mr. Cassidy, testified that this case was the first time in his tenure at the Commission that he had made such a recommendation.[14] Despite the fact that CCWC had been regulated through the use of its actual capital structure in its prior rate case and that no indication had been given to CCWC (or any water utility for that matter) that it should move to a different capital structure prior to filing this case, Commission Staff recommends the use of the hypothetical structure here.[15]

The practical effect of such a hypothetical capital structure is an effective ROE recommendation of 7.67%.[16] What is most shocking is that this recommendation was done without any analysis as to the impact of this new approach versus Staff's traditional approach (i.e., the use of the actual structure).[17] On cross-examination, Mr. Cassidy conceded that he did not undertake any analysis to examine the impact of the use of the hypothetical capital structure versus the use of Staff's standard adjustments.[18] Rather, he

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[12] Ex. S-2 at 8; Ex. A-11 at 9; Transcript ("Tr.") at 400.
[13] Tr. at 400-412; *see, e.g.,* Decision No. 74294 at 46; Decision No. 73996 at 7.
[14] Tr. at 400.
[15] Ex. A-11 at 10.
[16] Ex. A-12 at 10.
[17] Tr. at 388.
[18] *Id.*

testified that he recommended this major change in approach because it was "suggested" by another Staff member, presumably a supervisor, that he make this adjustment in lieu of another type of financial risk adjustment.[19] Once again, this was done without any analysis and, as testified by Ms. Ahern, this adjustment effectively reduced the cost of equity component by approximately 200 basis points.[20] On its face, this cost of equity recommendation is unreasonable and fails the tests set forth in the *Hope* and *Bluefield* cases described below.

When EPCOR purchased CCWC, it made no change to CCWC's capital structure, nor did the Commission or Commission Staff provide any indication in the docket in which it approved that purchase that CCWC should move to any new capital structure.[21] As noted above, Staff, in all recent filings prior to this rate case continued to recommend the use of the actual capital structure for purposes of setting rates.[22] Finally, when CCWC filed to refinance its existing debt with debt for which it would not pay down the principal (which would have the effect of maintaining the debt to equity percentages), Commission Staff rejected that approach in favor of a standard mortgage type financing that will have the effect, all things equal, of increasing the amount of equity.[23]

These signals all indicated a preference for the use of the Company's actual structure and an aversion to any requirement that CCWC change its capital structure. Yet, despite these signals, Commission Staff recommended in favor of the hypothetical structure in this case to "encourage" the Company to balance its capital structure.[24] Even if this Commission did want to urge CCWC to move to a more balanced capital structure, CCWC would require time to do so. In matters in which the Commission has desired to "encourage" such a change, it has historically required the utility to put forth a plan to do

[19] *Id.*
[20] Ex. A-12 at 10.
[21] Ex. A-12 at 5-6; Decision No. 72259.
[22] Ex. A-12 at 10.
[23] Decision at 74388; Tr. at 433-34.
[24] Tr. at 431.

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so or to make a commitment to do so prior to its next rate case.[25] This approach makes sense, as it is not sensible or practical for a utility to change its capital structure overnight. The only means for CCWC to adjust the capital structure are to issue dividends and/or to issue more debt.[26] Both of these take time. Under Arizona law, there are limits on the amount of dividends that can be issued.[27] In addition, the Commission has historically looked very closely at dividends.[28] Furthermore, increasing the amount of debt takes time and requires Commission approval. Based on recent experience for CCWC's refinancing, a single approval to refinance debt can take more than twelve months.[29]

Neither Staff nor RUCO did any analysis on how CCWC could or should move to a different capital structure. In Mr. Parcell's view, "the Company can do whatever it wants."[30] However, not only is that response untrue, it is disingenuous and again highlights the irresponsible results-based nature of this hypothetical capital structure recommendation by both Staff and RUCO.

a. Staff's Double Leverage Argument Has No Basis or Relevance

In his surrebuttal testimony, in an apparent effort to bolster Staff's hypothetical capital structure recommendation, Mr. Cassidy, without any evidence to support such a claim, alleges that "double leverage" exists.[31] According to Mr. Cassidy, double leverage is an issue: "[i]f a parent company issues debt and allocates it down to a regulated utility subsidiary while characterizing this financial support as equity capital."[32] Putting aside that it is not the source of the funds that is important for

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[25] Decision No. 68310 at 9, 15; Tr. at 407.
[26] Tr. at 200-201.
[27] A.R.S. § 10-833.
[28] *See, e.g.*, Decision No. 73736 at 32 ("Furthermore, we caution AWC that future cutting in the areas of system maintenance, as opposed to administrative and dividends, will be thoroughly scrutinized in AWC's next rate case.")
[29] Decision No. 74388.
[30] Tr. at 347.
[31] Ex. S-3 at 4.
[32] *Id.*

purposes of determining the ROE, but rather the risk of the investment, in this case, the evidence is clear that EPCOR has in no way used debt to allocate funds to CCWC as equity.[33] As Ms. Ahern explained in her testimony, a simple review of the Company's financials, which the parties had as part of discovery, would have made this clear.[34] Instead, Staff simply viewed the capital structures of CCWC's affiliates and concluded that double leverage must exist: "Staff considers these variances in capital structure between CCWC and both its ultimate and immediate parent to be *prima facie* evidence that double leverage is present."[35] Of course, Ms. Ahern's testimony makes clear that it could not exist, which shows the double leverage argument cannot be used as support for the hypothetical capital structure recommended by Staff.

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b. RUCO's Support of the Hypothetical Capital Structure is Without Merit.

RUCO's support of the hypothetical capital structure is also without any merit. Mr. Parcell recommended the use of the company's actual capital structure in his direct testimony.[36] Although Mr. Parcell testified at the hearing that he changed his position because he had "seen the light", this must be seen for what it is—an unsupported, after-the-fact attempt to reduce the Company's revenue requirement.[37] In fact, as noted above, when Mr. Parcell testified for Commission Staff in the Company's prior rate case, he also recommended the use of the Company's actual capital structure.[38] It is beyond reason to believe that Mr. Parcell's "expert" opinion changed from 8.7% on December 9, 2013 to 7.98% on February 7, 2014, when he admitted that he made no other adjustments during that time, but simply adopted Staff's hypothetical capital structure.[39]

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[33] Ex. A-12 at 4-8
[34] Ex. A-12 at 5-6
[35] Ex. S-3 at 4.
[36] Ex. R-7 at 15-16.
[37] Tr. at 315.
[38] Ex. R-9.
[39] Ex. R-7; Ex. R-8; Tr. at 327-28.

2. Cost of Equity

As noted above, the use of the hypothetical capital structure provides a rate of return that is clearly below any reasonableness standard. However, even if the Company's actual capital structure is used, both RUCO and Staff still recommend rates of return on the Company's equity that are below what is reasonable and appropriate. In its *Bluefield* decision in 1923, the United States Supreme Court set forth the criteria for determining whether a rate of return is reasonable:

> A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended b corresponding risks and uncertainties . . . . The return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain its credit and enable it to raise the money necessary for the proper discharge of its public duties. A rate of return may be reasonable at one time and become too high or too low by changes affecting opportunities for investment, the money market, and business conditions generally.[40]

The Supreme Court further held that "[r]ates which are not sufficient to yield a reasonable return on the value of the property used at the time it is being used to render the service are unjust, unreasonable and confiscatory, and their enforcement deprives the public utility company of its property in violation of the Fourteenth Amendment."[41]

In its later *Hope* decision, the Court gave further definition to the standard:

> [T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.[42]

Consistent with these decisions, under *Hope* and *Bluefield*, the following must be used as guidance:

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[40] *Bluefield Water Works & Improvement Co. v. Pub. Ser. Comm'n of West Virginia*, 262 U.S. 679, 692-93 (1923).
[41] *Id.* at 690.
[42] *Fed'l Power Comm'n v. Hope National Gas Co.*, 320 U.S. 591, 603 (1942).

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(1) The return should be similar to the return in businesses with comparable risks;

(2) The return should be sufficient to ensure confidence in the financial integrity of the utility; and

(3) The return should be sufficient to maintain and support the utility's credit.

a. The Commission Should Adopt a Cost of Equity of 10.5 Percent.

As is often the case, the dispute over cost of equity arises around the models used and the expert analysis given to those models to determine what is appropriately a comparable return to be adopted by the Commission.[43] In her testimony, Ms. Ahern, an expert with impeccable credentials and vast experience, provides ample and credible support for her cost of equity recommendation.[44]

As noted by Ms. Ahern, because CCWC's common stock is not publicly traded, a market-based common equity cost rate cannot be determined directly for CCWC.[45] Therefore, Ms. Ahern appropriately arrives at her recommendation through the use of a proxy group of companies with relatively similar, although not identical, risks.[46] Because no proxy group can be selected that is identical to CCWC, using her expert judgment, the results of the proxy groups must be adjusted to reflect the unique financial and business risks of the Company.[47]

Unlike Commission Staff, which relied solely on one model, which is contrary to the Efficient Market Hypothesis ("EMH"), Ms. Ahern relied upon the application of market-based cost of common equity models, including the Discounted Cash Flow ("DCF") model, the Risk Premium Model ("RPM") and the Capital Asset Pricing Model ("CAPM"), to the market data of the proxy group of nine water companies.[48]

[43] Ex. A-10; Ex. A-11; Ex. A-12.
[44] *Id.*
[45] Ex. A-10 at 5.
[46] *Id.* at 5-6, 25-42.
[47] *Id. at* 4-8
[48] *Id.* at 25-42.

Ms. Ahern continued to adjust her results during the pendency of this proceeding based on more recent data.[49] After reviewing the cost rates based upon each of the models, Ms. Ahern conservatively concluded that these models produced a common equity cost rate of 9.8% before her recommended adjustments for financial/credit risk and business risk related to CCWC's greater credit and business risks relative to the proxy group of nine water companies.[50] Based on her analysis, Ms. Ahern found that the common equity cost rate based upon the proxy group must be adjusted upward by 0.32% to reflect CCWC's credit risk and upward by 0.40% to reflect CCWC's greater business risk.[51] Her findings, which were based on this extensive analysis, are summarized below: [52]

	Proxy Group
Discounted Cash Flow Model	8.24%
Risk Premium Model	11.44%
Capital Asset Pricing Model	9.77%
Indicated Common Equity Cost Rate (before Adjustments)	9.80%
Credit Risk Adjustment	0.32%
Business Risk Adjustment	0.40%
Indicated Common Equity Cost Rate	10.52%
Recommended Common Equity Cost Rate (rounded)	10.50%

b. Staff's Cost of Equity Analysis Should Be Given No Weight

Mr. Cassidy, contrary to the extensive analysis done by Ms. Ahern, relied upon only one model in making his recommendation—the DCF model.[53] In doing so, Mr. Cassidy ultimately arrives at an ROE recommendation of 9.6%.[54] Consistent with the

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[49] Ex. A-11.
[50] Ex. A-11 at 69-70 at Ex. PMA-2, Sch. 11R.
[51] *Id.*
[52] *Id.*
[53] Ex. S-2.
[54] Ex. S-3 at 6.

Efficient Market Hypothesis, of which Mr. Cassidy claims to be a proponent, multiple cost of common equity models should be relied upon.[55] Mr. Cassidy's exclusion of the CAPM is both inconsistent with Staff's previous positions and with the Efficient Market Hypothesis upon which his DCF analysis is predicated.[56]

As noted above, Ms. Ahern's testimony provides substantial evidence that upward credit risk and business risk adjustments to the common equity cost rate based upon the market data of the sample utilities are necessary. These adjustments are necessary due to CCWC's likely bond rating and its small size. Mr. Cassidy did not make these adjustments.[57] Quite the contrary, Mr. Cassidy relied upon a hypothetical capital structure to instead reduce the effective cost of equity by almost 200 basis points.[58]

As explained by Ms. Ahern, a proper inclusion of these adjustments, coupled with a properly applied CAPM analysis and a properly applied DCF analysis based upon Mr. Cassidy's DCF, results in a 10.42% common equity cost rate, which is in line with the Company's updated recommendation.[59]

c. RUCO's Cost of Equity Recommendation Is Not Reasonable

Mr. Parcell recommends a cost of equity of 9.35%.[60] As noted above, Mr. Parcell made no adjustments to his cost of equity recommendation between the time of his direct testimony and the time of rebuttal testimony—except one major adjustment, which was the unsupported adoption of Staff's hypothetical capital structure.[61] Although Mr. Cassidy recognized a need to increase his cost of equity recommendation by 30 basis points during that time based on his analysis using the DCF model, Mr. Parcell undertook no additional analysis and made no other adjustments.[62]

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[55] Ex. A-11 at 15-16.
[56] *Id.*
[57] *Id.* at 31-35.
[58] Ex. A-12 at 10.
[59] Ex. A-11 at 35.
[60] Ex. R-7; Ex. R-8.
[61] Tr. at 327.
[62] *Id.*; Ex. S-3.

As noted by Ms. Ahern, Mr. Parcell's application of the CAPM is flawed in several respects and should not be relied upon.[63] As Ms. Ahern testified, Mr. Parcell incorrectly relies upon an *historical* risk-free rate even though ratemaking and the cost of capital are prospective.[64] He also incorrectly calculates his market equity risk premium by relying upon (i) the actually achieved, or non-market based, rates of return on book common equity for the S&P 500; (ii)a geometric mean historical market equity risk premium; and (iii) the historical <u>total</u> return on U.S. Treasury securities.[65] Furthermore, Mr. Parcell fails to employ a prospective equity risk premium.[66] Mr. Parcell also fails to utilize any upward credit risk or business risk adjustments even though the evidence supports such adjustments due to CCWC's small size and likely bond rating.[67] As set forth in detail in her testimony, when these adjustments are included, and when the CAPM analysis is properly applied, the result is a 10.59% ROE, which is in line with the Company's requested 10.50% ROE.[68]

D. RATE BASE/REVENUE REQUIREMENT

1. Post Test Year Plant

As noted above, both the Company and Commission Staff have recommended identical net plant in service amounts, which in part results from Staff and the Company agreeing on the amount of post-test year plant.[69] RUCO, however, despite there being no dispute that this plant is in service and despite there being no argument regarding the validity of the amounts for such plant, continues to rely upon an arbitrary six-month end point for post-test year plant.[70] As a result, RUCO recommends an adjustment in the

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[63] Ex. A-11 at 37-48.
[64] *Id.* at 39-40.
[65] *Id.* at 40-46.
[66] *Id.* at 46.
[67] *Id.* at 60-61.
[68] *Id.* at 50, 60-62.
[69] Company's Schedules; Staff's Schedules.
[70] RUCO's Schedules; Ex. R-13 at 7-8; Tr. at 691.

amount of approximately $1.7 million to remove those amounts and related depreciation.[71]

As is the current policy for Commission Staff, the Company has provided support and is seeking to include in rate base post-test year plant for the period ending one year after the test year.[72] Staff has reviewed the amounts for these additions and supports the inclusion in rate base of the entire amount of post-test year plant requested by the Company as being used and useful and appropriately included in rate base.[73] Despite requesting an update on all amounts through December 31, 2013, RUCO has only recommended including amounts through June 30, 2013.[74] RUCO confirmed during the hearing that it had received all invoices and did not take issue with any of the amounts of invoices.[75] Regardless, RUCO continues to recommend denial of these additional amounts. RUCO's reasoning behind this six month cut-off is that "it encourages, if, you know, RUCO is not going to go out for a full year, then . . . obviously it encourages companies to put their post-test year plant in the ground, get it used and useful."[76] This arbitrary distinction ignores that all post-test year plant being requested by CCWC is used and useful and providing benefits to customers. It is not good policy for companies to rush projects simply to meet RUCO's six month deadline. Rather, Company's should make responsible and timely decisions throughout the year, as is the case with CCWC.

2. 24 Month Deferral of Depreciation and AFUDC

Depreciation, unless recovered in rates, immediately begins to drain a utility's earnings, resulting in reduced returns on equity.[77] The inability to recover the return and the associated depreciation when new plant is put into service until a new rate decision is

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[71] RUCO's Schedules.
[72] Company's Schedules; Staff's Schedules; Ex. A-19 at 6-8; Ex S-10 at 3.
[73] Tr. at 581-82; 585.
[74] Ex. R-13 at 7-8; Tr. at 691-92.
[75] Tr. At 691-92.
[76] Tr. at 689-90.
[77] Ex. A-6 at 13.

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issued has long been referred to as "regulatory lag."[78] In an effort to address this regulatory lag, Commission Staff, in a Report dated March 19, 2012, recommended that the Commission use a twenty-four month deferral approach in the same manner as requested by CCWC in this matter.[79] Staff's Report discussed the recommendation in detail and its own words provide guidance as to the basis for its recommendation:

> Under present treatment, utilities record projects in the CWIP accounts and are allowed to record AFUDC on those balances using a rate that equals the utility's cost of capital. Upon transferring the cost of the completed project from CWIP to UPIS, the recording of AFUDC ceases and the utility begins depreciating the asset. During the interim period between the transfer from CWIP to UPIS and the date when the asset may be recognized in rate base, the utility bears the carrying costs of the asset which are unavoidable and unrecoverable under the present regulatory process. Once a project is completed, it is transferred to UPIS.
>
> Staff recommends that some consideration be given to mitigating the effects of carrying costs of net plant additions between rate proceedings. Under optimal conditions, a utility would transfer plant to UPIS concurrently with filing a rate case which would require up to 12 months to process. In addition, Staff prefers 12 months of data after a Company has received new rates before it can file another rate case. Realistically, the utility will bear the carrying costs of the incremental net plant additions during the interim period which is at least 24 months. While the utility is technically not entitled to earn on that incremental plant absent a fair value determination, Staff recommends that some consideration be given to mitigate effects of associated carrying costs which could be significant. **Staff recommends the deferral of post-in-service AFUDC for a period of up to 24 months to mitigate the effect of regulatory lag.**
>
> Staff also recognizes that a utility records depreciation expense from the date that the asset is placed into service. If this occurs during or prior to the end of the test year in a rate proceeding, the utility incurs depreciation expense but has no opportunity to recover it. Similar to the reason associated with regulatory lag discussed more fully above regarding post-in-service AFUDC, **Staff further recommends that depreciation expense be deferred for a period of up to 24 months to mitigate the effects of regulatory lag.** [80]

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[78] *Id.* at 13-14.
[79] Ex. A-33; Ex. A-6 at 14.
[80] Ex. A-33 at 2-3 (emphasis added).

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This deferral mechanism would allow the deferral of financing costs (AFUDC) and depreciation throughout the test year beginning on the first day of the test year, which in this case is January 1, 2012.[81] As requested by CCWC, the deferrals continued on any plant placed in service throughout the test year and for the following twelve months *(i.e.* the twenty-four months requested here).[82]

Although both Commission Staff and RUCO have rejected CCWC's request for this deferral mechanism, they do so based upon a faulty premise and attempt to make the Company's request sound illogical.[83] It is important to note that CCWC first made this request following Staff's issuance of its Staff Report as part of a stand-alone filing. In that proceeding, both RUCO and Staff indicated that this type of request should be made in a rate case.[84] Following that advice, CCWC made the request here. However, Staff and RUCO have continued to provide no principled basis for the rejection of the deferral.

As explained by Ms. Hubbard, the deferral would be unnecessary if rates could be adjusted to provide a return on investment in a shorter period of time than is now the case.[85] However, given the use of the historic test year and the time to process a case, such is not the practical reality.[86] Given the practical reality, CCWC strongly agrees with Staff that this 24 month deferral mechanism is an appropriate means to address regulatory lag.[87]

Despite the claim to the contrary, this request in no way seeks to recover amounts that would be recovered by CCWC under the SIB mechanism.[88] As noted by Ms. Hubbard, this 24-month deferral mechanism is intended to recover a return on and of assets placed in service on the first day of the test year through the 24-month period that

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[81] Ex. A-6 at 14.
[82] *Id.*
[83] Ex. 5-8 at 16; Ex. R-13 at 19-23; Ex. A-6 at 14.
[84] Ex. R-13 at 20.
[85] Ex. A-6 at 14
[86] *Id.*
[87] *Id.*
[88] *Id.* at 14-15.

ends with the issuance of the decision.[89] In this case, there is no potential overlap as the Company's calculation does not include the time period in which the SIB mechanism would be in place.[90]

As set forth in the Company's Final Schedules, CCWC deferral request is in the amount of $473,463 to reflect AFUDC on actual additions to plant and actual depreciation expenses on that plant during the 24-month deferral period.[91]

3. CAP Deferral

As part of this Application, CCWC is seeking to include the amounts deferred in its prior rate case related to CAP costs in which the Commission found CCWC's purchase of the additional CAP allocation to be a prudent expenditure but deferred fifty percent of M&I capital costs for consideration in this matter.[92] Staff, based on its review of the evidence, has correctly found those amounts to appropriate and has included them in rate base.[93] RUCO, however, resurrects all of its original arguments pertaining to the additional CAP allocation in CCWC's last rate case.[94] RUCO's arguments relate to the purchase price of the additional CAP allocation as well as the approval by the Commission to allow deferral of 50 percent of the M&I capital costs. RUCO's recommendation is to exclude the deferred balance authorized by the Commission from rate base and to eliminate any recovery of the previously deferred amount.[95]

As noted above, Commission Staff supports CCWC's request in this case to begin recovering the deferred and ongoing CAP M&I capital expense relating to this critical, renewable resource. By including these additional amounts, customers will receive the

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[89] *Id.*
[90] *Id.*
[91] Ex. A-2 at Sch. B-2 at 6.
[92] Decision No. 71308 (Ex. A-13); Ex. A-25 at 2.
[93] Staff's Schedules; Tr. at 899-900.
[94] Ex. A-26 at 1-2; A-6 at 16-17; Ex. R-13 at 11-18.
[95] Ex. R-13 at 11-18; Ex. A-13.

appropriate price signals for the costs incurred to provide CCWC's customers with adequate resources.[96]

RUCO continues to question the amount of the additional allocation that is needed and used and useful.[97] The Company continues to believe that the allocation is needed to continue to meet the needs of its customers now and in the future.[98] As Mr. Lenderking explained in great detail, it is not prudent for a water utility to have only enough water supply to meet the needs of its customers in only a single year.[99] Customer demand is variable.[100] In fact, in CCWC's territory, customer demand has changed by as much as 22.5% in just two years.[101] In addition, it must be understood that the amount of the allocation available to CCWC, recommended by ADWR and approved by the United States Department of the Interior, was a set amount *(i.e.* 1931 acre feet).[102] CCWC was not given the option to purchase any amount that it desired, and it was made clear at the time that this allocation would not likely be available again.[103]

Just as it is prudent for CCWC to have purchased this additional allocation, it is also prudent and sound public policy for the Commission to allow CCWC to recover the costs associated with that prudently purchased allocation. Therefore, the Company, as supported by Commission Staff, seeks to include the full unamortized balance of deferred CAP capital costs in rate base.[104]

4. Cash Working Capital

As shown in the chart below, the Company continues to disagree with Staff and RUCO regarding the appropriate amount of cash working capital.[105]

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[96] Ex. A-6 at 16; Ex. A-25.
[97] Ex. R-13 at 12-18.
[98] Ex. A-25 at 2-9; A-26 at 12.
[99] *Id.*
[100] Ex. A-26 at 1-2.
[101] *Id.*
[102] Ex. A-26 at 5-7.
[103] *Id.*
[104] Company's Schedules.
[105] Company's Schedules at Sch. B-2; Staff's Schedules at GWB-3; RUCO's Schedules at JMM-3.

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Company	Staff	RUCO
$161,335	$122,251	$111,842

The inappropriate nature of the use of a hypothetical capital structure is highlighted in the cash working capital calculation.[106] Not only does the hypothetical capital structure misstate the true cost of capital but it also impacts other components of rate base, such as cash working capital.[107] Both Staff and RUCO use hypothetical interest expense based on their recommended hypothetical debt.[108] Rather than use the actual interest expense (about which there is no dispute), Staff and RUCO use an amount based on hypothetical debt which severely overstates the interest component and the associated effect on the cash working capital for CCWC.[109] Even if the revenue requirement is based on the hypothetical capital structure, which it should not be, interest payments will only be paid on the actual debt outstanding which is far less than proposed in the hypothetical structure.[110] As a result, not only does the hypothetical capital structure reduce the overall rate of return, it understates the cash working capital requirement of CCWC (as well as income tax expense as noted below).[111]

Both Staff and RUCO also argue that regulatory expense should be excluded from the calculation of cash working capital.[112] Regulatory expense is the expense to prepare and litigate rate proceedings before the Commission and consists of cash expenditures to cover this expense.[113] As Ms. Hubbard explained in her testimony, this item of cash working capital has traditionally been included in the cash working capital calculation

[106] Tr. at 824-826; Ex. A-6 at 17-18; Tr. at 69-70.
[107] Ex. A-6 at 17-18.
[108] Ex. A-6 at 17-81; Tr. at 69-70; Ex. R-16.
[109] Ex. A-6 at 18.
[110] *Id.*
[111] Ex. A-6 at 19.
[112] *Id.*
[113] *Id.*

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for CCWC's affiliates.[114] The exclusion of this amount results is an unsupported understatement of cash working capital, which is unfair to the Company and should be rejected.[115]

Finally, for purposes of computing the customer accounting expense, the bad debt expense that arises due to the authorized increase in revenue is added to the adjusted test year level of customer accounting expense in the cash working capital calculation.[116] Although Staff corrected this item, RUCO continues to inappropriately exclude this additional customer accounting-related expense.[117] Once again, this is an adjustment that is traditionally made by the Commission and there is no basis for its exclusion here.[118]

E. Operating Income Issues

1. Depreciation Expense

Aside from its use of the hypothetical capital structure, the most surprising and unsupported change in policy in this case is Staff's recommended change in methodology for depreciation. Although Staff refers to this approach as the Vintage Method, it is not the Vintage Method as recommended by NARUC.[119] Rather, Staff's "modified" Vintage Method is a creation of Staff that seeks to use the whole group depreciation rates set by Commission Staff more than 10 years ago and pretend that these also apply to the "modified" Vintage Method proffered by Staff.[120] This approach also ignores NARUC guidance for how to implement the Vintage Method.[121] Furthermore, what is clear when that guidance is reviewed is that the very issues Staff is trying to remedy with its recommendation would continue to exist if the Vintage Method were

[114] *Id.*
[115] *Id.*
[116] *Id.* at 21-22.
[117] *Id.*
[118] *Id.*
[119] Ex. A-32 at 176-180; Tr. at 954.
[120] Ex. A-34; Ex. S-6 at Ex. KS at 12-13.
[121] Tr. at 954; Ex. A-32.

appropriately applied.[122] Rather than change the depreciation method, an approach which would be very costly (the cost of which would most likely be borne by ratepayers) and time consuming, a more appropriate approach, as ultimately recommended by CCWC, would be to revise depreciation rates to more properly reflect the service lives of the group of assets for which Staff has taken issue.[123]

There is no claim in this case that CCWC improperly depreciated accounts. In fact, both Staff and RUCO concede that CCWC followed the requirements of its prior rate case decision in relation to depreciation.[124] There is also no claim that CCWC failed to make proper retirements, and once again both Staff and RUCO concede that this new approach to depreciation is not being driven by improper retirements as was the case in prior Commission dockets.[125]

Rather, Staff (and ultimately RUCO) believes that certain accounts are "over depreciated", and as such, adjustments must be made.[126] And, rather than adjust depreciation rates for the two accounts at issue, Staff (and ultimately RUCO) has recommended a completely new depreciation methodology that is not supported by NARUC, but is rather the creation of Commission Staff.[127]

The progression of the positions of Staff and RUCO on the issue of depreciation is telling. In its initial filing, Staff recommended a major adjustment to accumulated depreciation (backward looking) and an adjustment to depreciation expense (forward looking) based on its belief that certain accounts were "over depreciated."[128] To accomplish these adjustments, Staff recommended that the Commission adopt its

[122] Ex. A-32 at 43, 195 (confirming depreciation accrues until plant is retired).
[123] Company's Schedules at Sch. C-2; Tr. at 853-54.
[124] Tr. at 932-34; 643-44.
[125] *Id.*; *see, e.g.,* Decision No. 74294 at 18.
[126] RUCO's Schedules; Staff Schedules; Ex. S-11 at 6-11.
[127] Tr. at 930 ("I based it on conversations I had with other Staff members as to how it had been proposed and/or adopted in other cases.").
[128] Ex. S-8 at 14-17, 22.

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"modified" Vintage Method of depreciation.[129] However, by the time of the hearing, in its amended surrebuttal testimony, Staff, without much explanation, dropped its adjustment to accumulated depreciation based on its "modified" Vintage Method (backward looking) and instead only recommended its adjustment to depreciation expense.[130] Putting aside that fundamental fairness makes any retroactive application of this new approach inappropriate, any retroactive application would also have been inconsistent with the requirements of the NARUC Uniform System of Accounts, which are incorporated into the Commission's rules on depreciation and provide:

> Changes in depreciation or amortization estimates or methods are considered changes in accounting estimates rather than accounting errors; and therefore are not subject to prior period adjustments.[131]

RUCO, in its direct testimony, made no mention of depreciation methodology. However, apparently after review of Staff's testimony, determined that, if the Commission were to require the use of the "modified" Vintage Method as proposed by Staff, the Commission should only do so on a prospective basis in the apparent recognition that CCWC had complied with Commission orders relating to depreciation and should not have this method applied to the 2012 test year expenses:

> Q. Does RUCO have any additional recommendations regarding plant additions and deletions?
>
> A. Yes. That the Company use the group asset per account by vintage year methodology of depreciation ***on a going forward basis.*** Further, ***if the Commission is inclined to adopt this methodology going back to the Company's prior rate case*** then Staff's adjustment to accumulated depreciation and depreciation expense should be accepted.[132]

Of course, as noted above, it is fundamentally unfair and against the Uniform System of Accounts to adopt this new methodology going back to the prior rate case.

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[129] Ex. S-10 at 8.
[130] Ex. S-11 at 3-10.
[131] UNIFORM SYSTEM OF ACCOUNTS FOR CLASS A WATER UTILITIES, Accounting Instruction 8.C. (1996), incorporated by AAC R14-2-411.D.2.
[132] Ex. R-15 at 42 (emphasis added).

However, notwithstanding its sworn testimony on this issue, RUCO, consistent with its approach on the hypothetical capital structure, inexplicably reversed course in its final schedules and adopted Staff's depreciation expense adjustment.[133] This new adjustment has no basis and should not be accepted.

a. Staff's "Modified" Vintage Approach Should Not Be Adopted.

What became clear during the hearing is that nothing is clear regarding the basis for Staff's depreciation methodology and how it is to be implemented. Staff did not base its methodology upon NARUC's Vintage Method guidelines.[134] In fact, Staff had not seen or reviewed the NARUC guidance in making its recommendation.[135] That guidance makes clear that a proper application of the Vintage Method would require a depreciation rate for each vintage year of each asset group.[136] The use of Staff's standard depreciation rates for the whole group method is not appropriate if the Vintage Method is to be properly applied.[137] Furthermore, as made clear by NARUC, whether it is the vintage method or the whole group method, a utility must continue to depreciate an asset until retirement.[138] Staff's artifice would require that an entity cease depreciating an asset prior to that asset reaching the end of its useful life.[139] This highlights the fact that the issue is with the depreciation rates, not the methodology. Accordingly, it is more appropriate, as recommended by CCWC, to change depreciation rates to reflect a more appropriate useful life for those assets.

b. The Commission Should Adopt the Revised Depreciation Rates for Accounts 311000 (Pumping) and 341100 (Transportation)

During the hearing, CCWC agreed that a revision to the depreciation rates for Accounts 311000 (Pumping) and 341100 (Transportation) would be more appropriate

[133] RUCO's Schedules at JMM-5
[134] Tr. at 930, 954.
[135] *Id.*
[136] Ex. A-32 at 176-80.
[137] *Id.*
[138] *Id.* at 43, 195.
[139] Tr. at 875.

than a wholesale change to the Company's depreciation methodology.[140] This approach would also avoid the unnecessary expense of modifying the Company's (and its affiliates') accounting systems to accomplish the change to depreciation methodology.[141] In the Company's Schedules, the Company adopted a revised depreciation rate of 8% (12.5 years) for the pumping account and a revised depreciation rate of 10% (ten years) for the transportation equipment account.[142] Ms. Hubbard's testimony at the hearing supports this revision.[143] Furthermore, even though Staff continues to recommend its "modified" vintage approach, Staff admits that the depreciation rate revisions would accomplish the same objective:

> If you have evidence of over-recovery, it would suggest that the rate is probably too high. You know, Staff's position is Staff's position. Our first choice is just to exclude it. Okay? Lowering the rate on the overall amount effectively does the same thing, more or less.[144]

Given that much uncertainty exists about the approach recommended by Staff, and given that a revision to the depreciation rate would accomplish the same result, CCWC strongly urges the Commission to adopt a revision to the depreciation rates. If the Commission finds that there may be value in a change to the methodology, this should only be adopted with additional, extensive analysis and input from all interested and affected parties.

2. Tank Maintenance

CCWC's system includes eight finished water reservoirs and one raw water reservoir with in-service dates ranging from 1972 to 2005.[145] CCWC has conservatively proposed a tank maintenance plan of eighteen years "to ensure that maintenance occurs at a frequency that balances the timing necessary to effectively extend the life of these

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[140] Tr. at 853-54; Company's Schedules at Sch. C-2.
[141] Tr. at 760.
[142] Company's Schedules at Sch. C-2.
[143] Tr. at 853-54.
[144] Tr. at 950.
[145] Ex. A-18 at 6.

assets through maintenance activities and in a manner that is not overly burdensome to customers."[146] This request is based on the number of tanks in the district, the size of those tanks, the age of the tanks and the material from which they are constructed.[147] As Mr. Stuck explained, it would be reasonable to conduct this maintenance at a more rapid pace, thus increasing the annual cost, but he believes that the proposed approach strikes the right balance of timing and cost.[148]

Staff, consistent with the approach approved by the Commission in prior cases, recommends the approval of this plan and the inclusion of the requested amounts as an expense item.[149]

RUCO, however, argues against this tank maintenance plan, and instead recommends a deferral, which would delay the recovery of these amounts until the next rate case.[150] Despite some confusion in RUCO's testimony about what the Company is requesting here and what the Commission has approved in prior cases, there is no dispute that the Commission approved a similar tank maintenance plan (and its inclusion as an expense) for CCWC's affiliates in Decision No. 71410 (for multiple water districts) and for the Sun City Water District as part of Decision No. 72047.[151]

As explained by Mr. Stuck, that approach has been an effective means to address the tank maintenance issues in those districts.[152] The condition of the tanks in the CCWC service territory is very similar to the condition of the tanks in the Sun City Water District, and the maintenance program being proposed here will bring the same "long term system benefits" that the Commission cited to for the Sun City Water District.[153]

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[146] *Id.*
[147] *Id.*
[148] Tr. at 479-80
[149] Staff's Schedules.
[150] Ex. R-13 at 37-38; Ex. R-13 at 24.
[151] Decision No. 72047 at 57-58; Decision No. 71410 at 36-37.
[152] Ex. A-20 at 3.
[153] Decision No. 72047 at 58.

3. Corporate Allocation; Incentive Compensation

Both Staff and RUCO propose a decrease to corporate allocation expense relating to incentive compensation.[154] Incentive compensation is an important component of salary and wages and, as the name implies, is intended to provide incentive for employees to work safely, efficiently, and effectively.[155]

Only ten percent of the incentive compensation is based on financial performance, which, as Ms. Hubbard testified, benefits consumers in the long run, while at the same time recognizing that the utility benefits from increased net earnings in the short term.[156] The remaining 90% of the incentive compensation is based on specific activities of the individual business units (department).[157] There are three broad categories of activities in the areas of Health and Safety, Operational Efficiency and Customer Service. Each category is weighted equally at 30%.[158] The purpose of this measure is to drive performance to engage and focus all employees on improving the business unit's performance as a service provider.[159] Because at-risk compensation is an integral part of the employees' salary, CCWC is opposed to any adjustment to the corporate allocation as a result of the positions of Commission Staff and RUCO.[160] CCWC also notes that the adjustment to incentive compensation at the CCWC level should be rejected for the same reasons.

Incentive compensation is part of an employee's compensation package and should be treated no differently than labor expense which is a cost of service.[161] By providing an at-risk compensation package as part of the compensation package for employees, well operated companies, such as EPCOR, are able to motivate employees to

[154] Staff's Schedules; RUCO's Schedules.
[155] Ex. A-6 at 23.
[156] *Id.* at 23-24.
[157] *Id.* at 24.
[158] *Id.*
[159] *Id.*
[160] *Id.* The financial component of the incentive compensation can be quantified at $8951.
[161] *Id. at 24.*

deliver results in line with the company's culture.[162] EPCOR's corporate culture stresses the importance of working safely and responsibly.[163] EPCOR also stresses the importance of delivering quality customer service whether it is communicating with the customers face-to-face or through accurate billing.[164] Another operational metric monitors capital expenditures to motivate employees to complete construction projects on time and under budget.[165] All of these metrics work together to provide benefits to customers.[166] Ultimately, these amounts are no different than a labor expense and should be treated in the same manner.[167]

4. Declining Usage

CCWC has requested a declining usage adjustment to decrease revenue by $65,960.[168] Declining usage is an adjustment to revenues to compensate for the impact of the declining residential usage per customer on the revenue requirement.[169] CCWC quantified this adjustment by calculating a 12-month moving average of the residential usage per customer for the last 3 years.[170] Next, annualized present rate residential revenues were computed to break out the proportion of revenue due to basic service (fixed) charges and commodity charges to quantify the proportion of residential revenue attributable to consumption charges.[171] Next, the declining residential usage percentage was multiplied by the length of time before the rates will become effective.[172] The product was applied to the consumption revenue to arrive at the residential revenue adjustment.[173] Because there will be roughly eighteen months (*i.e.* 1.5 years) between

[162] *Id.* at 23-24; Tr. at 114-18.
[163] Ex. A-7 at 6-7
[164] *Id.* at 7.
[165] *Id.*
[166] *Id.*
[167] *Id.*
[168] Ex. A-4 at 17.
[169] *Id.*
[170] *Id.*
[171] *Id.*
[172] *Id.*
[173] *Id.*

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the end of the test year and the time rates are likely to become effective in this case, the declining residential usage percentage is multiplied by 1.5 prior to being applied to the consumption revenue.[174]

Staff, based on its analysis of usage, also agrees that a declining usage adjustment is appropriate.[175] CCWC, as recommended by RUCO, is willing to provide an annual filing by March 30th of each year to show actual usage in the residential class.[176] Based on trends in usage, CCWC expects that these compliance filings will continue to demonstrate declining usage, further supporting the Company's request.

5. Water Loss

CCWC agrees with Commission Staff that water loss is an issue that must be addressed.[177] However, EPCOR, as a new owner of the system, believes it should be given an opportunity to address water loss before a punitive reduction in certain expenses is imposed.[178] As Mr. Stuck testified, CCWC requests that the Commission, as a compliance requirement, allow it to file a plan to continue to reduce water loss as the Commission has ordered in many other matters.[179] EPCOR has demonstrated since taking ownership of CCWC that its approach to water loss is working and requests that it be allowed to continue to work these plans without the need for the adjustment to power and chemical expenses proposed by Staff.[180]

6. Property Tax Expense

The parties continue to dispute the appropriate assessment ratio for purposes of determining property tax expense. Commission Staff has averaged the assessment rates

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174 *Id.*
175 Ex. S-8 at 26.
176 Ex. A-6 at 22.
177 Ex. A-19 at 2-4.
178 *Id.* at 4. As Mr. Stuck explained in his testimony, there is no correlation between water loss and increased power expense. Tr. at 480-81. As such, it is not appropriate to use that component of the adjustment.
179 Ex. A-19 at 4.
180 *Id.* at 3-4.

for 2014 through 2016 to reach a rate of 18.5%.[181] RUCO, as part of its initial testimony, used the 2014 rate of 19%.[182] However, in its surrebuttal testimony, as was the case for numerous issues, adopted Staff's three-year average of 18.5%.[183] The Company has continued to rely upon the 2014 assessment ratio of 19.0%.[184] The basis for doing so is that, despite the declining rates for property tax assessment, property taxes on a whole continue to rise as the ratio is only one factor in determining the amount assessed.[185] For example, as property values rise, property taxes will increase. Thus, it is appropriate to use the ratio in effect at the time that CCWC's rates go into effect (*i.e.*, 2014) to set an appropriate property tax expense in this case.[186]

7. Income Tax Expense

The difference in the recommended income tax expense is again driven by the recommendation of the use of the hypothetical capital structure.[187] Once again, both Staff and RUCO rely upon the hypothetical capital structure and the resulting overstatement of interest expense which leads to a recommendation of a hypothetical income tax expense.[188] There is no dispute that CCWC will pay its actual income taxes, based on the deduction of its actual interest expense, not its hypothetical income taxes determined using a hypothetical interest deduction.[189] Accordingly, it is not sensible to rely upon the hypothetical income tax expense and the adjustments made by Staff and RUCO should be rejected.

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[181] Staff's Schedules at GWB-18.
[182] Ex. R-13 at 39-40.
[183] Ex. R-14 at 26.
[184] Ex. A-30 at 4-5.
[185] Tr. at 180.
[186] Ex. A-30 at 4-5; Tr. at 180.
[187] Tr. at 824-825.
[188] *Id.*
[189] *Id.* at 825.

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F. Other Items in Dispute

1. CAP Surcharge

With its Purchased CAP Water Surcharge, CCWC is seeking to address changes in CAP related expenses as described in its plan of administration.[190] Each year, CAWCD re-examines the price for CAP water and those changes are significant, known and measurable.[191] As part of this Purchased CAP Water Surcharge request, CCWC will maintain complete records of invoices for the surcharge components and will submit that information for Commission review as part of its requests.[192] As proposed, CCWC will prepare an annual filing that will include a calculation of the annual purchase water costs and the projected annual purchased water costs for the following year.[193] The tariff filing will also contain the prior year's water deliveries and appropriately calculate the rate per thousand gallons that should be assigned based on the actual historical costs.[194] The surcharge request will include the prior year's balance, positive or negative.[195] The surcharge will not be assessed until approximately one year after new rates are implemented after a decision in this case.[196] In subsequent years, a tariff filing will be due to the Commission approximately on the anniversary of the first surcharge's implementation.[197]

CAP water is a critical renewable resource for CCWC and is a large component of CCWC's operations and maintenance expense.[198] In the last rate case, the Commission allowed purchased water expense which represented 18.5 % of the allowed operation and

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[190] Ex. A-25 at 9-15. At the request of Staff, the Company agreed at the hearing to change the name of its Sustainable Water Surcharge. Tr. at 538-39.
[191] Ex. A-25 at 9-12.
[192] *Id.* at 11.
[193] *Id.*
[194] *Id.*
[195] *Id.*
[196] *Id.*
[197] *Id.*
[198] *Id.* at 12.

maintenance expense for the Company.[199] In this case, the test year CAP expense represents 19.8% of the test year operations and maintenance expense request.[200] The basis for this change is that CAP water expense has increased 31.4% over this time while O&M expenses have only increased by 22.7%.[201]

The use of this surcharge will allow for the exact recovery of this known and essential expense, and, when faced with CAP water price increases, it will allow for a healthier utility.[202] Also, the surcharge, as proposed by CCWC, will address changes in growth as part of its calculation, which is a concern for RUCO.[203]

CAWCD has been faced with rapidly increasing costs and shortfalls in revenue which have begun to deplete its reserves.[204] It is well known that CAWCD faces many issues which could lead to substantial increases in the cost of CAP water.[205] These issues are exactly why this surcharge should be approved so that CCWC can receive full recovery of such a vital expense each year after the expense has occurred.[206] Just as purchased power is critical to the electric industry (and thus subject to a surcharge), purchased water is critical to the water industry.

Staff, in recognition of the value of this renewable resource, recommends its approval.[207] RUCO, however, recommends the denial of this surcharge and the use of an erroneously created average CAP water price to arrive at its recommended purchased water expense.[208] Although both Staff and CCWC agree that the adjusted test year purchased water expense should be expensed, both also recognize that the proposed

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[199] *Id.*
[200] *Id.*
[201] *Id.*
[202] *Id.* at 13.
[203] Tr. at 529.
[204] Ex. A-25 at 14.
[205] *Id.*
[206] *Id.*
[207] Ex. S-8 at 25.
[208] Ex. A-26 at 5.

mechanism will be used to pass through increases or decreases in costs above or below the adjusted purchased water expense, which is reflective of purchased CAP water.[209]

EPCOR has several other water districts which use CAP water and that already have pass-through mechanisms for CAP-related expense.[210] EPCOR staff, who will be administering this surcharge mechanism, have direct experience in implementing CAP expense recovery mechanisms and has gained knowledge and skill over the years.[211] The Company's Plan of Administration reflects that knowledge and was proposed to model the Sun City and Sun City West surcharge mechanisms for ease of preparing the calculations for submittal and ease of review and subsequent approval by Staff.[212]

For all of these reasons, the Commission should approve the Company's Purchased CAP Water Surcharge.

2. SIB Mechanism

Quite simply, CCWC has complied with all requirements for the implementation of a SIB mechanism. CCWC has provided extensive information in relation to SIB Table I, and Commission Staff has analyzed that information in great detail.[213] CCWC prepared and submitted an extensive SIB Eligibility Report supporting in detail the need for the SIB mechanism within CCWC's service territory.[214] Based on its extensive review, Staff has concluded that CCWC has met the criteria first set forth in the settlement agreement in the Arizona Water Company Eastern District matter and applied in multiple cases since that time.[215]

CCWC's testimony makes clear that CCWC is willing to abide by the Commission's requirements for the SIB mechanism and that it has the technical expertise

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[209] *Id.*
[210] *Id.* at 4-5
[211] *Id.*
[212] *Id.*
[213] Ex. A-23; Ex. S-6 at 15.
[214] Ex. A-22.
[215] Ex. S-6 at 15.

and commitment to submit the required information as part of its future SIB filings.[216] As recommended by Commission Staff, CCWC is also willing to file its Plan of Administration as a compliance item in this case within 30 days of a decision and will conform that Plan of Administration to the form recommended by Staff and agreed to by CCWC.[217]

Despite the overwhelming evidence in support of the SIB mechanism in this case, RUCO has continued to proffer its rejected legal arguments in opposition to the SIB.[218] The Commission has rejected these arguments in multiple proceedings as of the date of this brief.[219] It is likely that the Commission will do so in more decisions prior to the date of a decision in this matter. Without repeating all of those legal arguments here, CCWC notes that it supports and incorporates the legal conclusions in those decisions and continues to believe that the SIB mechanism will withstand any legal challenge if RUCO continues to challenge the SIB mechanism.

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3. Rate Design

CCWC continues to oppose the rate design recommended by Commission Staff, which includes a large discount on the first tier.[220] By reducing this first tier below that of the current first tier rate, customers receive inappropriate pricing signals, *i.e.*, that water is less expensive than before, which is not the case.[221] In addition, these tiered rates, as proposed by Commission Staff, make it extremely difficult, if not impossible, for CCWC to achieve its authorized revenue requirement.[222] Mr. Bourassa, who performed the Company's cost of service study, explained in detail the risk of under-recovery that is exacerbated by Staff's rate design:

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[216] Ex. A-21 at 3.
[217] Ex. A-7 at 13; Tr. at 511-13.
[218] Ex. R-13 at 46; Tr. at 602-03.
[219] Decision No. 73938; Decision No. 74081; Decision No. 74364.
[220] Company's Schedules (H Schedules); Ex. A-6 at 30.
[221] Ex. A-6 at 30.
[222] *Id.*

> Water/wastewater utilities are very capital intensive. Most of the costs that you look at in a cost of service study are what I will call fixed costs. They are there regardless of the amount of water that is sold. And typically in rate designs that have been adopted by the Commission, some portion of the fixed cost is actually recovered through the commodity rates. And you don't get commodity revenues unless you sell water. So if there is any risk to, or if there is a risk to selling all the water you need to cover your costs, then you are going to have that risk of underrecovery.
>
> And it is exacerbated by the fact that we use inverted tier rates. Why? Because we actually --inverted tier rates means that we have a low cost rate at the front end and a higher cost rate as more water is used. And what typically happens then is that more of the cost recovery is up in the higher usage blocks, but that's a design that encourages conservation. So if you actually experience conservation, you are not going to recover all of your cost of service.
>
> ****
>
> One example of what I mean is if you look at --actually, let's look at Exhibit A-2, Schedule G-9, page 1. This schedule reflects a breakeven analysis based on the rate design that the company proposes. You will see that the breakeven point isn't until somewhere between 8- and 9,000 gallons of water usage. So by the first tier, which is the lowest commodity rates, we are selling water well below its true cost, to the tune of, this schedule shows which is my rebuttal schedule, $12.26. So that's what I mean by there is substantial risk in rate design, because we are not even reaching a breakeven point until that 8- or 9,000-gallon breakeven point. And I don't believe that our average usage --our average usage is, for the residential meter, is right at 8,000 gallons. So conservation, if we lower that average down, we are not even reaching our breakeven point.[223]

Recently, in two water utility rate cases, the Commission recognized issues with these rate designs and the risk of under-recovery.[224] In both of those cases, the Commission revised Staff's recommended rate design by increasing the fixed charge.[225] The same issues that the Commission recognized in those cases exist in this case but on a larger scale.

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[223] Tr. at 547-49.
[224] Decision No. 74391 at 11; Decision No. 74398 at 17-18.
[225] Decision No. 74391 at 11; Decision No. 74398 at 17-18.

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4. Miscellaneous Service Charges

CCWC's miscellaneous service charges for items such as after-hours and regular hours establishment of service should be directly related to the costs to provide such services.[226] Staff recommends rejecting the Company's proposed charges and instead relies upon lesser rates for these services that are not tied to actual costs.[227] The Company continues to recommend the adoption of its proposed fees and believes that charging the actual costs for these services is appropriate as it allows the Company to recover those costs and sends appropriate price signals to customers.[228]

RESPECTFULLY SUBMITTED this 4th day of April, 2014.

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By ______________________
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ORIGINAL and thirteen (13) copies
of the foregoing filed
this 4th day of April 2014, with:

The Arizona Corporation Commission
Utilities Division – Docket Control
1200 W. Washington Street
Phoenix, Arizona 85007

Copy of the foregoing hand-delivered
this 4th day of April, 2014, to:

Steve Olea
Utilities Division
Arizona Corporation Commission
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Phoenix, Arizona 85007

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226 Ex. A-6 at 28.
227 Staff's Schedules.
228 Ex. A-6 at 28.

Lyn Farmer
Chief Administrative Law Judge, Hearing Division
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